CAPTIVE INSURANCE COMPANY REPORTS

Bond Allocations for Captives

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Editor's Note: We now hear from **Carl Terzer**, a leading captive investment counselor, who will give you his thoughts on investing for captives. He can be reached at carl.terzer@capvisorassociates.com.

Captives, like all insurance companies, will usually have the bulk of their assets invested in bonds. Reserves, the captive's primary claims-paying fund, need to be prudently managed to assure the insurer's financial stability. Bonds, which typically provide low volatility/risk, as compared to most other asset classes, fit this objective. Income from the bond portfolio can also serve to pay current operating expenses and known claims. Asset liability management (ALM) techniques, when properly applied to the bond portfolio, immunize the portfolio against interest rate risk and liquidity risks when duration and cash flow matching, respectively, are properly applied. This has been the "modus operandi" for insurers for a long, long time.

The Inversion: Dividend Stocks Paying More Than Bonds?

Most investors understand that the Fed and other central bank "easy money" policies have created extensive market distortions over recent years. For example, the 10-year Treasury has had an average yield of more than 6 percent since 1965 but has fallen to less than 1.5 percent today. This is an all-time historic low! Add to that the fact that approximately one-third of developed-country sovereign debt offers negative interest rates. Traditional investment logic and fundamental analysis no longer apply to these markets.

As bond yields fall, their market values rise, creating an environment in which bonds look very expensive. Furthermore, a meager 1.5 percent yield has become relatively unattractive for captive insurers seeking to maximize income, particularly vis-à-vis the average dividend yield for the Standard & Poor's 500-stock index of about 2.1 percent.

In this yield-starved bond market, captives struggle to earn a "real return"—the nominal return/yield less the inflation rate. The risk of not earning a real return means the possibility of failing the captive's primary investment objective of "preservation of principal," which unchecked, would lead to a slow death spiral. Any investment program that results in a negative real return, such as a bank account or money market fund, eventually contributes to the likelihood of a terminal surplus scenario: in other words, bankruptcy. Even an investment portfolio of "safe" US Treasuries promotes this risk since one would need to go out past 5-year maturities to obtain a yield representing a "real" return.

Rightfully so, many captives and other insurers do not see any benefit in loosening credit quality restrictions within the investment-grade bond market as being a reasonable risk/reward tradeoff. The same can be said for the other obvious techniques to increase portfolio yields: increasing duration or interest rate risk exposure. This dilemma takes captives on a search for yield that would include asset classes that provide more attractive returns, notwithstanding additional risk, such as equities.

From most investors' perspective, and certainly from an insurer's, equities are arguably at the extreme opposite end of the risk spectrum from high-quality bonds. Equities, being lowest in an issuing company's capital structure, simply mean that recovery rates for stockholders in the event of default or bankruptcy are far lower than bonds holders. A stock's value can go to zero, their dividends are not assured payments, and the market value volatility level is multiples of that for high-quality bonds: approximately 12 percent versus 4 percent, respectively.

Notwithstanding, these risk elements investors, including insurance companies, have been piling into stocks (in particular, high dividend-paying stocks). Most experts agree that this party is almost over due to the price bubble that has been caused by this large influx of capital driving up prices. While there may still be some room to run, dividend achiever or dividend aristocrat strategies, as they are often called, face more risk than many insurers realize. Blindly chasing yield is never a sound strategy.

Looking for Yield or Higher Total Returns

With an overpriced bond market and an overpriced stock dividend strategy segment, where are captives to seek yield? Recalling that stocks and bonds lie on opposite ends of the risk spectrum, we would suggest that one of the first places to look would be at asset classes that lie somewhere in-between. The asset classes that might be considered will also depend on factors such as the regulatory environment, the financial strength of the captive, the reliability and length of its claims history, and its lifecycle stage, among other factors.

Asset allocation modeling will also indicate that there are asset classes that could and should be considered by captives. Why aren't these asset classes already a part of the typical captive portfolio? Most captive board members understand, and many personally invest in, the traditional investment-grade bonds and US large cap stock markets. They may be unaware of the "nontraditional" asset classes and their diversification benefits. Perhaps their investment advisers and portfolio managers do not have a core competency in managing those nontraditional asset classes and are therefore loath to suggest that money be removed from their firms to fund those allocations, just as you would not ask your family practitioner to perform brain surgery. In any event, "specialty" managers, rather than bond generalists or typical core bond managers, should be considered in the asset class deliberations that we will address below.

Until the recent recovery of the energy markets, **high yield bonds** looked scary. More recently, they have been rediscovered with strong investor inflows. This asset class offers diversification due to its relative low correlation to high-quality US bonds (.19) and to US stocks (.69). Adding low correlation asset classes to a typical portfolio of stocks and bonds tends to improve risk-adjusted returns as well as smooth out the return streams over market cycles. It is the beauty of diversification!

Adding diversifying asset classes to a captive's portfolio, in the appropriate increments, can even serve to decrease risk levels while increasing expected return levels—the proverbial "free lunch." However, determining the appropriate increments for adding allocations requires some homework. It would be strongly suggested that captives take advantage of asset allocation optimization analytics. The old and commonly used method of scribbling 80 percent fixed income/20 percent equities on the back of a napkin will not provide the intended results when allocations become more complex. Seldom can the "optimal" allocation for your captive be determined by chance.

Good investment opportunities do not wait around long to be discovered, and market participants have a way of arbitraging away excess returns quickly. Therefore, it is no surprise that **emerging market bonds** have been on a tear so far in 2016. Larger, later lifecycle stage captives are considering emerging-market bond mandates as they have gained nearly 8 percent through the first 6 months of this year. That rally has sent yields in emerging-markets bonds down a bit, but they're still relatively attractive—in the neighborhood of 5 percent or 6 percent for many emerging-markets bond funds currently.

After a strong showing in 2014 on both an absolute and relative return basis, **municipal bonds** again emerged as a top-performing asset class in 2015. Taxable municipals, as well as

MONTANA PREMIUM TAX REVENUE SINCE 2001

Year	Captives Licensed	Retired	Net #	Premium Tax	Premiums
2001	1	–	1	–	–
2002	4	–	5	$20,037	$8,750,200
2003	4	–	9	$51,713	$6,419,100
2004	5	3	11	$72,569	$7,690,736
2005	3	1	13	$86,696	$14,759,504
2006	8	–	21	$161,994	$31,580,902
2007	10	1	30	$226,168	$37,877,161
2008	8	3	35	$339,585	$65,123,909
2009	15	4	46	$420,070	$74,863,332
2010	26	5	67	$619,539	$88,724,747
2011	26	8	85	$804,583	$120,274,295
2012	34	5	114	$1,034,625	$165,605,660
2013	47	11	150	$1,385,155	$196,833,421
2014	34	7	177	$1,546,674	$227,206,651
2015	38	24	191	$1,689,834	TBD

tax-exempt municipals for US taxpaying captives, should be considered as part of a diversified bond allocation. For US-domiciled, and for offshore captives taking a 953(d) election, a properly blended bond portfolio of taxable and tax-exempt bonds will provide tax efficiency, a very important, but often overlooked, consideration. What you keep is more important than what you make!

Convertible bonds exhibit wonderful diversification characteristics with particularly low correlations to a captive's large bond portfolio (-.01) and even some benefit versus a captive's typically smaller stock portfolio (.86). These securities are debt instruments, a type of bond, that can be converted into a specified number of shares of common stock. Therefore, they share characteristics of commonly accepted and utilized captive portfolio asset classes but oddly are not themselves often considered as part of an asset allocation.

There are many considerations when looking at asset classes or diversification methods to improve captive portfolio returns, sometimes even also reducing overall portfolio risk. With expectations for our low-yield environment to continue for some time, captives would be prudent to learn more about how and which alternative fixed income asset classes might best suit their unique needs objectives and risk budget for improving portfolio performance.

CICR comment: Several domiciles—including Vermont, Arizona, and Delaware, among others—have reported increased licensures. Montana is also in the category and kindly provided the above information for your consideration (used with permission of the Montana Captive Insurance Association (MCIA) and provided to them by the State Auditor's Office).

As Montana's captive insurance industry has grown over the past several years, so does its positive economic impact in the form of premium taxes paid to the state. The information provided on the previous page illustrates the growth in premium tax revenue since 2001. MCIA expects this positive trend line will continue for many years to come.

The creation of over $1.5 million in state taxes is notable and should be so by noncaptive states.

COVERAGE WRITTEN BY MONTANA CAPTIVES

Captive insurance companies licensed in Montana are currently being used for many different types of corporate risks, including the following.

✔ Administrative Action	✔ Litigation Expense
✔ Agency Professional Liability	✔ Livestock Liability
✔ Attorney's Liability Reinsurance	✔ Medical Malpractice
✔ Aviation Liability	✔ On-Site Cleanup
✔ Bail Bond Liability	✔ Patent Defense
✔ Cable Repair, Communications Company	✔ Primary and Excess Liability
✔ Contractors Liability	✔ Punitive Damages Liability
✔ Contractual Liability	✔ Reinsurance
✔ Defense Costs	✔ Tax Audit Expenses
✔ Directors and Officers	✔ Third-Party Liability
✔ Employment Practices Liability	✔ Trucking Liability
✔ Environmental Liability	✔ Unfair Competition Liability
✔ Excess Property	✔ Wage and Hour Liability
✔ Excess Stop Loss	✔ Warranty
✔ Excess Workers Compensation	✔ Workers Compensation Deductible Buy-Down
✔ Liability	✔ Worldwide Cargo and Transit